No. 21306

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

PETER M. ELLIOTT, as Trustee in Bankruptcy for the Estate of HENRY H. HERRERA, dba U. S. EAGLE FERTILIZER CO. and GARDENLAND NURSERY, Bankrupt,

Appellant,

vs.

HENRY H. HERRERA, dba U. S. EAGLE FERTILIZER CO. and GARDENLAND NURSERY, Bankrupt,

Appellee.

APPELLANT'S OPENING BRIEF.

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Appellee,

APPELLANT'S OPENING BRIEF.

This is an appeal from an Order entered on July 22, 1966, by the Honorable Leon R. Yankwich, Senior United States District Judge, denying appellant's Petition for Review from an Order entered by the Honorable Robert B. Powell, Referee in Bankruptcy, which said Order was entered on March 2, 1966, and overruled appellant's Specifications of Objection to the Bankrupt's Discharge and granted the bankrupt a discharge from his debts.

I.
JURISDICTIONAL STATEMENTS.

On or about June 7, 1965, appellant, as trustee, filed with the Referee his Specifications of Objections to the Bankrupt's Discharge [R. 23].

After extensive hearings and testimony the Referee entered his Order on March 2, 1966, granting the bankrupt's discharge [R. 110]. On March 4, 1966, appellant filed his Petition for Review of said Order [R. 115] and thereafter on July 22, 1966, the Honorable Leon R. Yankwich, Senior United States District Judge, entered his Order denying said Petition for Review [R. 143].

On August 10, 1966, and within the time allowed by law, your appellant filed a Notice of Appeal [R. 144], and your appellant has taken the steps required by law in presenting the necessary record on the within appeal.

The jurisdiction of the Court of Appeals is invoked pursuant to Section 24 of the National Bankruptcy Act (Title 11 U.S.C. §47).

II.
STATEMENT OF FACTS.

In general, appellant, as trustee, objected to the bankrupt's discharge upon the following grounds, to wit:

(1) That the transfer by the bankrupt of the assets of U. S. Eagle Fertilizer Co. to Park Green Enterprises, Inc., a corporation, formed by his son for that purpose, was made with intent to hinder, delay and defraud and bankrupt's creditors.

(2) That the bankrupt failed to maintain adequate books and records from which his financial condition and business transactions might be ascertained.

(3) That the bankrupt has failed to satisfactorily explain losses of assets, in that he had failed to satisfactorily explain:

(a) The difference of a purported net worth of $169,772.00 as of September 30, 1963, and a deficit net worth of $128,532.00, as shown by the bankrupt's schedules, A DIFFERENCE OF SOME $298,000.00.

(b) The disposition of the $25,000.00 purportedly received from the sale of U. S. Eagle Fertilizer Co. assets.

There were other specifications but appellant concedes that the evidence would not support them and that the Referee properly overruled them.

The Referee's Findings of Fact and Conclusions of Law, it is submitted, are clearly erroneous and should be reversed by this Honorable Court. The Referee's Findings of Fact and Conclusions of Law are merely recitations of appellant's Specifications of Objections to Discharge with the phrase "It is not true that" tacked on the front.

The District Court, we must assume, adopted the Referee's Findings of Fact and Conclusions of Law, as the District Court Judge, at the hearing on the aforesaid Petition for Review on July 18, 1966, ruled from the bench that "In matters of this type, we must go along with the Referee."

The bankruptcy proceeding was instituted by the filing of an involuntary petition on March 20, 1964.

The bankrupt was engaged in business as a sole proprietor in the fertilizer and nursery business under the names of U. S. Eagle Fertilizer Co. and Gardenland

Nursery. The bankrupt's son, John or Johnny Herrera acted as the bankrupt's general manager and managed the fertilizer end of the business, at least.

On or about November 11, 1963, the bankrupt purportedly transferred the assets of U. S. Eagle Fertilizer Co. to a corporation formed by his son, John Herrera, for that purpose — said corporation being Park Green Enterprises, Inc. This transfer was on a sale and lease back arrangement with the bankrupt remaining in possession and operating until about the first of February, 1964, at which time Park Green Enterprises, Inc. apparently took over and the bankrupt then became the employee of Park Green Enterprises, Inc. The testimony is not clear as to the exact date when this transformation took place.

The aforesaid transfer by the bankrupt to the corporation formed by his son, was for the purchase price of $25,000.00, with the bankrupt leasing the assets back at $800.00 per month.

John Herrera's testimony was that part of the purchase price was acquired from his "savings" kept in a metal box in his home [Transcript, June 3, 1965, p. 22, lines 1-5; p. 23, lines 1-26]. The rest was "borrowed" from his relatives and $15,000.00 was "borrowed" from a concern named Horticultural Products, Inc.

Park Green Enterprises was formed in October, 1963 as a leasing business. The first assets it ever had were the U. S. Eagle Fertilizer Co. assets, which it leased to the bankrupt for $800.00 per month, and a bank account. Park Green had no other operating income until approximately the first of February, 1964, yet for the period of November 11, 1963 to January 31, 1964, Park Green's bank account shows deposits of over $40,000.00!

[Trustee's Ex. 13]. This is the bank account from which the $25,000.00 came from for the purchase of the U. S. Eagle assets.

As will be noted from trustee's Exhibit 13, a considerable portion of the deposits came from Horticultural Products, Inc., which eventually ended up with a chattel mortgage on the U. S. Eagle assets. It is also interesting to note that the opening deposit into Park Green's bank account on November 11, 1963, included a cashier's check from the bankrupt.

As will also be noted from the Bankrupt's Answers to Second Set of Interrogatories, the bankrupt's income from Horticultural Products stopped at the time when checks from Horticultural Products in odd amounts started being deposited in Park Green's bank account. However, the bankrupt was supposedly still in possession of the U. S. Eagle assets and operating until the end of January, 1964.

In May of 1963, a letter was prepared and sent to the bankrupt's suppliers informing them that Horticultural Products, Inc. had purchased all of the U. S. Eagle business [Trustee's Ex. 6]. However, according to Mr. Turfryer's testimony this really did not come about [Transcript, September 11, 1964, p. 39, line 18; p. 42]. However, Horticultural Products eventually ended up with a chattel mortgage on all of these assets [Trustee's Ex. 11]. Mr. Turfryer testified that the consideration for the chattel mortgage was antecedent indebtedness of the bankrupt dba U. S. Eagle Fertilizer Co. [Transcript, September 10, 1965, p. 26; Transcript, September 11, 1964, p. 97, line 11; p. 99, line 14]. John Herrera testified, however, that the chattel mortgage was given to secure monies loaned from Horticultural to

Park Green to buy the U. S. Eagle assets [Transcript, June 3, 1965, p. 11, line 25; p. 12]. Eugene E. Glushon, the attorney for the bankrupt, represented Park Green and Horticultural Products in this transaction [Transcript, September 11, 1964, p. 94, lines 4-17].

The bankrupt's "books and records" turned over to the trustee consisted of one 40 gallon trash can and two fertilizer sacks and one small box filled with miscellaneous loose statements, invoices, correspondence, bank statements and some check stubs [Transcript, January 10, 1966, p. 25, line 17; p. 26, line 6].

Without going into specifics the entire testimony of Hal Riger [Transcript, August 28, 1964] and Gerald G. MacDonald [Transcript, September 10, 1965, October 12, 1965 and January 10, 1966] are replete with testimony that the bankrupt's records were such that his business transactions and financial condition could not be ascertained at any one time.

It is felt that the Court's particular attention should be called to the fact that the bankrupt's financial statement of September 30, 1963 [Trustee's Ex. 8] showed, among other things, accounts receivable in excess of $75,000.00, and the bankrupt's schedules [Trustee's Ex. 9] list accounts receivable of $8,000.00 as an asset.

According to the testimony presented to the Referee the status of the bankrupt's books and records were such that it is impossible to determine what specific accounts made up the $75,000.00 plus figure, *or* what specific accounts made up the $8,000.00 figure [Transcript, October 12, 1965, p. 8, line 23, to p. 10, line 12]. As to the $8,000.00 in accounts receivable scheduled as an asset by the bankrupt, appellant, as receiver and

trustee was and is unable to even send demand letters to the account debtors *because the bankrupt's books and records do not disclose who they are (if they do, in fact exist)*!

As to the disposition of the $25,000.00 received from the sale of the U. S. Eagle Fertilizer Co. assets, the bankrupt has testified that it "went back into the business." The trustee's accountant testified that the first two checks were deposited to the bankrupt's bank account and from this $3,200.00 went back to Park Green Enterprises, Inc. as "rent." The other checks [Trustee's Ex. 2] according to the bankrupt's testimony and the accountant's report [Trustee's Ex. 10] were cashed by the bankrupt. The bankrupt testified that this money was deposited to his bank accounts from time to time as needed. These three checks total $15,000.00, and the first of which was dated December 18, 1963. The accountant's report [Trustee's Ex. 10] reflects that all deposits to all of the bankrupt's bank accounts from and after December 18, 1963 totalled $11,621.94. Even assuming first that the bankrupt had no other revenue from and after December 18, 1963 (which the bankrupt has not contended) this is still approximately $3,400.00 unaccounted for.

The bankrupt's financial staetment as of September 30, 1963 [Trustee's Ex. 8] reflects a net worth of $169,772.00 while the bankrupt's schedules [Trustee's Ex. 9] reflect a deficit net worth of $128,532.00. This represents a loss of some $298,000.00 in the short period of about five months. *And, the record is completely void of any explanation of this whatsoever by the bankrupt.*

III.

SPECIFICATION OF ERRORS.

The Order of the United States District Court Denying Appellant's Petition for Review and in Effect Affirming the Referee Is Erroneous in That:

(1) The Order of the Referee is based on the following clearly erroneous findings of fact, to wit:

(a) It is not true that the bankrupt destroyed, mutilated, falsified, concealed or failed to keep or preserve books of accounts or records, from which his financial condition and business transactions might be ascertained, while engaged in business under the firm name and style of U. S. EAGLE FERTILIZER CO.

(b) It is not true that the bankrupt, on or about November 11, 1963, or at any time subsequent to the first day of the twelve months immediately preceding the filing of the petition in bankruptcy, transferred, removed, destroyed, or concealed, nor did the bankrupt permit some of his property to be removed, destroyed or concealed with the intent to hinder, delay, or defraud his creditors.

(c) It is not true that the bankrupt has failed to satisfactorily explain loss of assets or a deficiency of assets to meet his liabilities. It is not true that the bankrupt failed to ex-

plain the disposition of funds in the approximate sum of $25,000.00 received from the sale of the bankrupt's business, known as U. S. EAGLE FERTILIZER CO.

(2) The Order of the Referee is based on the following erroneous conclusions of law:

(a) The bankrupt did not destroy, mutilate, falsify, conceal or fail to keep or preserve books of account or records from which his financial condition and business transactions might be ascertained, and did not violate Section 14C (2) of the Bankruptcy Act.

(b) The bankrupt did not transfer or conceal any property within the twelve months immediately preceding the filing of the petition in bankruptcy, with the intent to hinder, delay or defraud his creditors, and did not violate Section 14C (4) of the Bankruptcy Act.

(c) The bankrupt did not fail to explain satisfactorily any loss of assets or deficiency of assets to meet his liabilities, or fail to explain the disposition of the proceeds received from a sale of his business, nor did the bankrupt violate Section 14C (7) of the Bankruptcy Act.

(3) The District Court was in error in denying appellant's Petition for Review from the Referee's Order.

IV.

SUMMARY OF ARGUMENT.

(A) THE FINDINGS OF THE REFEREE ARE CLEARLY ERRONEOUS.

(1) The Bankrupt Transferred Assets Within Twelve Months Prior to Bankruptcy With Intent to Hinder, Delay or Defraud Creditors.

(2) The Bankrupt Failed to Keep or Preserve Books and Records From Which His Financial Condition and Business Transactions Might Be Ascertained.

(3) The Bankrupt Has Failed to Satisfactorily Explain Losses of Assets.

(B) AT THE VERY MINIMUM, THE RECORD WAS SUFFICIENT TO SHIFT THE BURDEN OF PROOF TO THE BANKRUPT.

(C) THE REFEREE APPLIED THE WRONG STANDARD IN GRANTING THE BANKRUPT'S DISCHARGE.

V.

ARGUMENT.

Introduction.

The instant appeal, in substance, asks for this Honorable Court to determine the question of whether or not the bankrupt should be granted a discharge from his debts, over objections thereto, if he has not committed any of the acts specified by the Bankruptcy Act as a bar thereto; or whether the criteria is that he should be granted a discharge if to deny it would be of no benefit to his creditors.

As will be pointed out hereinbelow, the latter is the criteria employed by the Referee, and the evidence overwhelmingly sustains the objections to discharge despite the "blanket" findings signed by the Referee.

A. The Findings of the Referee Are Clearly Erroneous.

1. The Bankrupt Transferred Assets, Within Twelve Months Prior to Bankruptcy With Intent to Hinder, Delay or Defraud Creditors.

Section 14(c)(4) of the Bankruptcy Act [Title 11 U.S.C. §32(c)(4)] provides that the bankrupt's discharge should be granted unless satisfied that the bankrupt has:

> "at any time subsequent to the first day of the twelve months immediately preceding the filing of the petition in bankruptcy, transferred, removed, destroyed, or concealed, or permitted to be removed, destroyed, or concealed, any of his property, with intent to hinder, delay or defraud his creditors;"

It is well settled that proof of fraudulent intent is seldom capable of direct proof but must be inferred from the circumstances. *McWilliams v. Edmonson* (5th Cir. 1947), 162 F. 2d 454, cert. den. 332 U.S. 835; *Chorost v. Grand Rapids Factory Show Room, Inc.* (3rd Cir. 1949), 172 F. 2d 327; and here since the transferee was a corporation formed by the bankrupt's son and general manager, for that purpose, the transaction is subject to stricter scrutiny since the relationship of father-son and principal-agent was a fiduciary one, see *McWilliams v. Edmonson* (5th Cir. 1947), 162 F. 2d 454, cert. den. 332 U.S. 835 and Volume 4 Rem-

Collier on Bankruptcy (14th Ed.), Section 67.37(3).

The aforesaid amusing game of musical chairs whereby the bankrupt's son, who was also the manager of the bankrupt's business, ends up as the bankrupt's employer and with the bankrupt's assets still in the family, leaving the bankrupt with unpaid creditors of over $80,000.00, it is submitted, is the rankest kind of nepotism which should convince any Court that this bankrupt should not be discharged from his debts.

Even if we ignore, for the sake of argument, the foregoing fraudulent conduct, the bankrupt's testimony clearly and unequivocally shows that the purpose of the transfer was to avoid attachments by the bankrupt's creditors [Transcript, August 7, 1964, p. 21, lines 2-8]. *This alone would be sufficient* to deny the bankrupt's discharge, as this would constitute a hindrance of creditors as a matter of admitted fact. *In re Rowe,* United States District Court, E.D. N.Y., September 30, 1964, reported in C.C.H. Bankruptcy Law Reporter 61,194, October 28, 1964.

2. The Bankrupt Failed to Keep or Preserve Books and Records From Which His Financial Condition and Business Transaction Might Be Ascertained.

Section 14(c)(2) of the National Bankruptcy Act [Title 11, U.S.C. §32(c)(2)] provides that the bankrupt's discharge should be granted unless satisfied that the bankrupt has:

> "destroyed, mutilated, falsified, concealed, or failed to keep or preserve books of account or records, from which his financial condition and business transactions might be ascertained, unless the court deems such acts or failure to have been justified under all the circumstances of the case;"

As stated in Volume 1, Collier on Bankruptcy (14th Ed.), §14.30 on pages 1353 and 1354:

> "Although it has been stated generally, in issues raised on objections to discharge, that the provisions of §14 should be resolved in favor of the bankrupt, such a statement should be qualified by noting that the interests protected by clause (2) 'are those of creditors and that the bankrupt is required to take such steps as ordinary fair dealing and common caution dictate *to enable the creditors to learn what he did with his estate.*' Within the broad language of this provision, as defined by the exercise of a sound judicial discretion, if the facts disclose a breach of the bankrupt's duty to creditors to keep or preserve proper books or records and he fails to establish facts and circumstances in justification thereof, a discharge should be denied.
>
> *The requirement is imposed to enable creditors, with the assistance of proper books and records, to ascertain the true status of the bankrupt's affairs and to test the completeness of the disclosure requisite to a discharge*". (Citations omitted and emphasis added).

In the case of *In re Brod* (D.C.N.D. Ga., 1909), 166 Fed. 1011 the court denied the bankrupt's discharge on the grounds that he had concealed, destroyed or failed to keep books and records from which his financial condition might be ascertained, where there was a shrinkage of $10,000.00 in a bankrupt's assets within a period of thirteen months, and the bankrupt failed to show from his books what became of his property.

In the instant case we have not only the disposition of the $25,000.00 received from the sale to Park Green Enterprises but the loss of some $298,000.00 in the period of five months, neither of which is reflected by the bankrupt's books and records. And, as mentioned hereinabove there are absolutely no records reflecting the nature, extent or disposition of the accounts receivable.

3. The Bankrupt Has Failed to Satisfactorily Explain Losses of Assets.

Section 14(c)(7) of the Bankruptcy Act [Title 11 U.S.C. §32(c)(7)] provides that the bankrupt should be granted a discharge unless satisfied that the bankrupt:

> "has failed to explain satisfactorily any losses of assets or deficiency of assets to meet his liabilities."

In this particular we are concerned with the disposition of the $25,000.00 received by the bankrupt in connection with the transfer of the assets to Park Green Enterprises and with an explanation of how the bankrupt's financial condition changed from a net worth of $169,772.00, as shown by the financial statement of September 30, 1963 [Trustee's Ex. 8] and a deficit net worth of $128,532.00 at the date of bankruptcy some five months later. As to the latter point, the bankrupt did not give even a semblance of an explanation, and it is submitted that it is apparent no plausible explanation could be given. As to the said $25,000.00, only approximately $10,000.00 was shown to have been deposited to the bankrupt's bank account.

As stated in Vol. 1 Collier on Bankruptcy (14th Ed.) §14.60 at pages 1436 and 1437:

> "An explanation which is based mostly upon an estimate of the bankrupt, *founded upon nothing by way of verification or affirmation by means of books, records or otherwise* has been held unsatisfactory. Even though the underlying facts referred to by a bankrupt may suggest a plausible explanation, the testimony may be so general as to be insufficient. *More is required of the bankrupt in the way of explanation than mere generalities.*" (Emphasis added.)

From the "explanations" of the bankrupt we cannot rule out the possibility that some of the aforesaid $25,000.00, which was converted into cash, went into the bank account of Park Green Enterprises [Trustee's Ex. 13]. The desirability of avoiding speculations such as this is just the reason why Congress has seen fit to enact Sections 14(c)(2) and 14(c)(7) of the Bankruptcy Act.

As the Court stated in denying the discharge of a bankrupt in *In re Shapiro & Ornish* (D.C. Tex. 1929), 37 F. 2d 403, aff'd *Shapiro & Ornish v. Holliday* (5th Cir.), 37 F. 2d 407, at page 406:

> "The word 'satisfactorily', as contained in the amendment referred to, may mean reasonable, or it may mean that the Court, after having heard the excuse, the explanation, has the mental attitude which finds contentment in saying that he believes the explanation—he believes what the bankrupts say with reference to the disappearance or the shortage. He is satisfied. He no longer wonders He is content".

In the instant case, not only did the bankrupt not say anything, from what he did say, we must still wonder—we must still be discontented.

B. At the Very Minimum, the Record Was Sufficient to Shift the Burden of Proof to the Bankrupt.

It is submitted by appellant that the District Court and the Referee failed to place the necessary importance on the 1926 amendment to Section 14(c)(7) of the Bankruptcy Act [Title 11 U.S.C. §32(c)(7)], which states:

> "Provided, That if, upon hearing of an objection to a discharge, the objector shall show to the satisfaction of the court that there are reasonable grounds for believing that the bankrupt has committed any of the acts which, under this subdivision c, would prevent his discharge in bankruptcy, then the burden of proving that he has not committed any of such acts shall be upon the bankrupt."

As stated in Volume 1 Collier on Bankruptcy (14th Ed.) §14.12 at page 1314:

> "This statutory provision alters the earlier construction of the statute adopted by the cases. The burden which shifts now upon a showing of reasonable grounds is not a *burden of going forward* with the evidence requiring the bankrupt to explain away natural inferences, but a *burden of*

proving that he has not committed the objectionable acts with which he has been charged;—If the evidence is in a state of substantial equilibrium, the discharge must be denied since the bankrupt has failed to carry his burden of proof." (Emphasis, the author's; Citations omitted).

As stated by the Court, in *Federal Provision Co. v. Ershowsky* (2nd Cir., 1938), 94 F. 2d 574:

"The amendment of 1926 has revolutionzied the procedure in discharge; the bankrupt may no longer remain inert, standing upon the infirmities of the evidence against him; once a prima facie case appears, the laboring oar passes to his hands and he must bring the boat to shore. It is he who has caused the loss, who has access to the facts, and who alone knows what the explanation is; let him make it, let him satisfy the court that it really explains. Else he will not be discharged. We cannot see how the judge, or any other impartial person, could think that these bankrupts had explained anything whatever."

In the instant case, it is submitted, that the evidence introduced by appellant is overwhelmingly sufficient to sustain the objections to discharge, and the bankrupt did not bear his burden of proof.

C. The Referee Applied the Wrong Standard in Granting the Bankrupt's Discharge.

Rather than considering the evidence presented by appellant and considering the above matters which, it is submitted, could *only* lead to the denial of the bankrupt's discharge, the Referee felt that it would not do the creditors any good and therefore granted the bankrupt's discharge.

As stated by the Referee in making his decision [Transcript, January 10, 1965, p. 36, lines 10-23]:

> "THE REFEREE: Ready for the decision? This bankruptcy has been pending about three years. We have had copious amounts of testimony. We have had Mr. Joe Potts in here who looked like he was going to make a veritable lifetime job out of this. Finally, we had to separate Mr. Potts and some of the witnesses and attorneys. *So, we are all of the opinion that Mr. Herrera must have been one of the biggest crooks in the world; and, then, the books and records are not in too good shape, but I don't think it will do the creditors a bit of good to deny his discharge;* and from a practical standpoint, let's don't waste too much time and argument here despite all the evidence that Mr. MacDonald cleverly made in the exhibits that I struck. So, I will allow his discharge" (emphasis added).

VI.
CONCLUSION.

It is submitted that the record clearly shows that the bankrupt, by his acts and conduct has not placed himself outside of the provisions of Section 14 of the Bankruptcy Act, and his discharge should be denied. It is also submitted that the Referee's Findings of Fact, Conclusions of Law and Order are clearly erroneous and the District Court's Order denying Appellant's Petition for Review is erroneous for the reason that the Referee applied the wrong standard in holding that the bankrupt is entitled to a discharge because, as a practical matter, it would do his credtiors no good to deny it.

It is therefore respectfully submitted that the District Court's Order denying appellant's Petition for Review should be reversed and the bankrupt's discharge should be denied.

Respectfully submitted.

Craig, Weller & Laugharn,
By Robert A. Fisher,
Attorneys for Appellant.

Certificate.

I certify that, in connection with the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Robert A. Fisher

APPENDIX.

Exhibit	Transcript Of:	Page Reference to Where Exhibits Were Identified, Offered, Received or Rejected
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